BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

Opinion of the Court Below.

The opinion of the United States Circuit Court of Appeals for the Third Circuit was handed down on the 1st day of March, 1945. It is embraced in the printed record, pages 40-42, and is reported in 148 F. (2) 62.

II.

Jurisdiction.

The date of the judgment to be reviewed is March 1, 1945. The jurisdiction of this Court is involved under Section 240 of the Judicial Code as amended by Act of February 13, 1925, 43 Stat. 938; Sec. 347 of Title 28 U.S.C.A.

III.

Statement of the Case.

This case involves additional income taxes determined against the petitioner for the year 1940 in the amount of twenty dollars ninety cents ($20.90). But, as will subsequently appear, the question is of more importance than the small sum immediately involved indicates.

John S. Mack, father of the petitioner, died testate on September 27, 1940, while a resident of McKeesport in Allegheny County, Pennsylvania. His Last Will and Testament (Stipulation of Facts, Exhibit "1A", Appendix, pages 16 a-24 a) was duly admitted to probate in

the Orphans' Court of Allegheny County, Pennsylvania. Mr. J. Paul Fife and The Union Trust Company of Pittsburgh are the duly qualified and acting executors and testamentary trustees of the will. (Appendix, page 14 a). By paragraph "Eighth (b)" of the will, the decedent established a testamentary trust for the benefit of the petitioner and others. (Appendix, page 19 a). The paragraph is so important in this case that it is set out here in full. It reads as follows:

> "Eighth: All the rest, residue, and remainder of my estate, real, personal and mixed, whatsoever and wheresoever situate, I give, devise and bequeath unto THE UNION TRUST COMPANY OF PITTSBURGH and J. PAUL FIFE, ESQ., in trust for the following uses, persons and purposes, and with the following powers:
>
> (b) I direct that my Trustee shall set aside Twenty Thousand (20,000) shares of my common capital stock of G. C. MURPHY COMPANY for the benefit of my sons, JOHN GORDON MACK and JAMES S. MACK, and the institutions hereinafter mentioned. At any time during the first ten (10) years after the date of my death my Trustees shall sell and deliver to my said sons said Twenty Thousand (20,000) shares and any stock dividends thereon, or such part thereof as they shall from time to time elect to purchase, *at one-half (½) the average market price per share as hereinafter defined, each son to be entitled in the aggregate to one-half (½) of said Twenty Thousand (20,000) shares and stock dividends, unless the other should fail or refuse to purchase his full one-half of the total.* For the purpose of this paragraph average market price per share during any calendar month shall be *the mean*

between the high and the low of the market price of said stock during the six (6) calendar months immediately preceding the date of the particular purchase, and the price at which my sons shall be entitled to purchase said stock from time to time shall be one-half (½) said average market price. The net proceeds of each such sale and the net cash dividends from said stock (or so much of the stock as shall not have been sold to my sons) after deduction of proper charges and expenses applicable thereto, shall be paid to the following in the proportions indicated:

The Mack Foundation (created by me during my lifetime),	45%
Endowment Fund, Westminster College, New Wilmington, Pa.	20%
Bob Jones College, Cleveland, Tennessee,	20%
Southwestern Presbyterian Sanatorium, Albuquerque, New Mexico,	15%

At the expiration of ten years from the date of my death, such part of said Twenty Thousand (20,000) shares of capital stock and stock dividends thereon as my said sons shall have failed or refused to purchase shall be sold to any purchaser or purchasers at the best price obtainable, as soon as conveniently may be and as soon as may be for the best interests of my estate, and the proceeds thereof shall be paid to the aforementioned institutions in the percentages indicated. My Trustees may, however, at their discretion, if so requested by my sons or either of them, extend beyond said ten year period the time within which said sons or either of them may purchase the shares of stock then remaining unsold,

but such extension shall in no event exceed a period of two years and six months." (Italics supplied).

On November 25, 1940, under the above paragraph "Eighth (b)" of the will, the petitioner acquired five shares of the common capital stock of the G. C. Murphy Company from the testamentary trustees. The correct basis of these shares on subsequent sale by the petitioner in 1940 is the question involved in this petition.

Petitioner paid the trustees $170.30, or $34.06 a share in cash for the stock, whereas the mean average market price of the shares during the six calendar months immediately preceding the purchase by the petitioner was $67.625 per share. (Stipulation of facts, Appendix, page 15 a), or $338.125 for the five shares. And for the six months ended August 31, 1940, the mean average market price was $69.50 per share (idem), or $347.50 for the five shares. At the date of the death of the decedent, September 27, 1940, the fair market value of the shares was $78.00 per share, or $390.00 for the five shares (Appendix, page 15 a).

On December 31, 1940, petitioner sold the five shares for $69.224 per share (net) or a total of $346.12. (Appx., 15 a) And in his income tax return for 1940 he reported a short term capital loss on the sale, as follows: (Appendix, page 16 a)

Cost or other basis	$360.30
Expenses of Sale	3.26
Total	$363.56
Less gross Sales Price	349.38
Loss to be taken into account	$ 14.18

Respondent determined, as a matter of law, that the basis was \$170.30, or \$34.06 per share, instead of \$360.30, or \$72.06 per share, as reported. Respondent held that under applicable sections of the Internal Revenue Code he could allow only the cash paid by petitioner for the shares as a basis and had to treat the option acquired by inheritance as of no value in the basis (Appendix, page 16 a).

Other 1940 sales of capital assets, not in dispute, resulted in a short term capital gain of \$113.83. Consequently, petitioner reported a net short term capital gain of \$99.65. He arrived at the net figure by subtracting the loss of \$14.18 from the undisputed gain of \$113.83 (Appendix, page 16 a).

The change in legal treatment of the basis of the shares by the respondent was to eliminate all value for the testamentary option and to confine basis to actual cash paid under that option for the shares, even though petitioner acquired them, by virtue of the option, for a price equivalent to one-half of the preceding six-months' market. The G. C. Murphy Company shares were continuously quoted on the exchange, as it is a very large and variously-held domestic corporation, operating over five hundred large stores commonly known as "Five and Ten Cent Stores".

On November 24, 1942, the petitioner filed a petition in The Tax Court of The United States praying that the deficiency in income tax be redetermined and that The Tax Court find that the adjusted basis of the said five shares of G. C. Murphy Company common stock in the hands of petitioner was not less than \$72.06 per share, consisting of \$38.00 ascribable to the option and \$34.06 to the cash paid by him to the trustees and

that there was no deficiency in income tax for the year 1940 against the petitioner. The facts were stipulated by the parties and the Stipulation of Facts is found at R. 15 a, *et seq.*

The case was submitted to The Tax Court on stipulation and on February 29, 1944, The Tax Court rendered its decision in favor of the respondent. However, five judges of The Tax Court dissented, one without opinion, and one with a dissenting opinion in which three others concurred. The dissenting opinion pointed out that it was unrealistic to treat the right of the petitioner to purchase stock at one-half its market value as having no value and to exclude it from the basis of the shares (R. 34 a). The dissenting opinion held that the petitioner acquired some property of value by bequest from his father, which ripened into the acquisition of the stock, and that the value of the bequest must necessarily have an effect upon petitioner's basis for the stock.

On May 19, 1944, the petitioner filed a petition for review of said decision of The Tax Court of The United States by the United States Circuit Court of Appeals for the Third Circuit. On January 11, 1945, the case was argued before the Circuit Court and on March 1, 1945, said Court rendered its decision affirming the Tax Court's decision (R. 40). The Circuit Court's opinion is, in effect, based on the proposition that because an option in a lease giving the lessee the right to purchase the demised real estate is not an asset of the lessee's in the form of said land prior to the exercise of the option, it follows that a bequest from a father to a son of the right to purchase shares of stock from testamentary trustees at one-half their market price cannot be included, at whatever its value, in the basis of such shares

in the hands of the son. This conclusion the Circuit Court derived from the decision of this Court in *Helvering v. San Joaquin Fruit and Investment Company,* 297 U. S. 496, *supra.*

IV.

Specifications of Error.

The United States Circuit Court of Appeals erred:

(1) In holding that the value of a bequest, by the petitioner's father, of the right to purchase stock at one-half the market price could not be combined with the amount petitioner paid trustees for the stock in an adjusted basis for the shares on their subsequent sale by the petitioner.

(2) In holding that, even though petitioner has exercised his right to purchase the stock, he cannot use any part of this valuable option as the basis for his stock.

(3) By holding in effect that the capital asset, sale of which resulted in a capital gain, was the shares of stock, that these shares were not an asset of the taxpayer until he exercised the option and that there was no combination of two capital assets,—the option and the $170.30 of cash, to form a new capital asset, the stock, which was subsequently sold at a loss.

(4) In holding that the decision of this Court in *Helvering v. San Joaquin Fruit and Investment Co.,* 297 U. S. 496, determines the instant case adversely to the petitioner.

(5) In holding that the taxpayer had a tax basis of only one-half the market price of the stock.

(6) In failing to adopt a realistic view of the facts of the case and in failing to hold that for all practical purposes the petitioner's father bequeathed him the stock as of the date of his death subject to payment to his trustees of one-half of its market value (according to the formula set forth in the will). *Helvering v. Hallock,* 309 U. S. 106.

V.

Summary of Argument.

The applicable pervisions of the Internal Revenue Code provide that the basis of property shall be the cost of such property (Sec. 111); except that, if the property was acquired by bequest or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition (Sec. 113 (a) (5). Therefore, the question in this case is what, if anything of value, did John S. Mack, the testator bequeath to his son, the petitioner, in giving him the right to acquire the stock at a bargain price. The Circuit Court in effect held that the testator bequeathed an option, similar to an option to purchase provided for in a lease for the rental of real estate, under the Eighth Paragraph of his Last Will and Testament, which is found at R. 16 a.

The right to purchase the stock at half price was bequeathed to the petitioner and under the law of Pennsylvania this right was property passing by bequest, and thus transmitted at death from the testator. The option as such a bequest thus falls squarely within the purview of Section 113 (a) (5) of the Internal Revenue Code, as amended.

VI.

Argument.

Both the Circuit Court of Appeals and the majority of The Tax Court were of the opinion that the case of *Helvering v. San Joaquin Fruit and Investment Company,* 297 U. S. 496, is similar to the case at bar. Actually, the facts are not alike at all. The San Joaquin case involved the lease of unirrigated land in California for a ten year term beginning December 1, 1906, and ending November 30, 1916, with the tenant having the right to purchase the property at the end of the term for $200,000. On November 30, 1916, the option was exercised and the lessee purchased the property for the sum of $200,000, and subsequently transferred it to the San Joaquin Fruit and Investment Company under conditions which made no change in the basis for gain or loss, that is, in a transaction in which gain or loss was not recognizable. Subsequently, in the period 1920 to 1928, the Company sold parts of the tract of land and it became necessary to determine the basis of the land sold during the period. The Commissioner used a basis of $200,000, which was the amount paid under the option. The taxpayer used March 1, 1913 value which was more than $200,000, on the theory that it had acquired the land by virtue of the option prior to March 1, 1913, which, under other well-known rules, permitted the use of the value of the land on March 1, 1913. It was held that the tenant had not acquired the real estate prior to March 1, 1913, and Mr. Justice Roberts stated that the option in the lease did not create an interest in land under the applicable California decisions. The learned Justice said in part:

"The capital asset, sale of which resulted in taxable gain, was the land. This was not an asset to the taxpayer prior to the exercise of the option."

The addition to basis of the increase in value of the San Joaquin option between 1906, when it was probably worth nothing, and March 1, 1913, when the value was large, was, in a sense, fictitious. It constituted a non-tax-paid addition to basis. In our case the option had a non-derived value as of September 27, 1940 (the date of decedent's death and is "estate-tax-paid", and is thus in harmony with the whole taxation system set up in the Internal Revenue Code. Iu short, the first addition (to March 1, 1913) is unrealistic and the second (a value in the option) is undoubtedly and distinctly realistic.

In the San Joaquin case it was important whether or not the tenant had acquired the land prior to March 1, 1913; and inasmuch as the option could not be exercised prior to November 30, 1916, it is quite obvious that he had not. As in the case at bar, the petitioner acquired the G. C. Murphy Company stock option on September 27, 1940. Section 113 (a) (5) fixes basis for property so "acquired" as its value at the date of the death of the decedent. No legatee has to accept anything that a testator bequeaths to him, if he doesn't want it; but as soon as he accepts it and complies with whatever conditions the testator has attached to it, the bequest is complete and dates back to the date of decedent's death. *Helvering v. Reynolds,* 313 U. S. 428. If the petitioner's father had left him this stock, subject to a debt for which it had been pledged as collateral in an amount equal to one-half its market value, certainly he would be permitted to add his father's equity in the

stock to the amount of the debt in determining his basis for such stock.

In the San Joaquin case, the tenant's option to purchase had no market value at the time it was given and became valuable only as the property increased in value over the sum of $200,000 and the increase in basis was fictitious. If, on the date when the option to purchase was to be exercised, November 30, 1916, the property was worth only $200,000, the option would then have no market value. However, if the tenant had been given the option to purchase the real estate at one-half the market price, the option would have had a market value at the time it was given and also on the day when it was to be exercised, whether the value of the property increased, decreased or remained the same. In the case at bar, the petitioner's bequest had a value on the date of his father's death and every day up until the day petitioner received the stock from the trustees and paid them one-half of its market price.

In the case of *Commissioner of Internal Revenue v. Smith,* 65 Sp. Ct. Rep. 591, Chief Justice Stone said:

> "In certain aspects an option may be spoken of as 'property' in the hands of the option holder. Cf. *Helvering v. San Joaquin Fruit & Investment Co.,* 297 U. S. 496, 498, 56 S. Ct. 569, 570, 80 L-Ed. 824; *Shuster v. Helvering,* 2 Cir., 121 2d 643, 645. When the option price is less than the market price of the property for the purchase of which the option is given, it may have present value and may be found to be itself compensation for services rendered. But it is plain that in the circumstances of the present case, the option when given did not operate to transfer any of the shares of stock from the em-

ployer to the employee within the meaning of Sec. 22 (a) and Art. 22 (a)-1. Cf. *Palmer v. Commissioner,* 302 U. S. 63, 71, 58 S. Ct. 67, 70, 82 L. Ed. 50. And as the option was not found to have any market value when given, it could not itself operate to compensate respondent. It could do so only as it might be the means of securing the transfer of the shares of stock from the employer to the employee at a price less than their market value, or possibly, which we do not decide, as the option might be sold when that disparity in value existed. Hence the compensation for respondent's services, which the parties contemplated, plainly was not confined to the mere delivery to respondent of an option of no present value, but included the compensation obtainable, by exercise of the option given for that purpose. It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise could not be found to be the only intended compensation.

The Tax Court thus found that the option was given to respondent as compensation for services, and implicitly that the compensation referred to was the excess in value of the shares of stock over the option price whenever the option was exercised. From these facts it concluded that the compensation was taxable as such by the provisions of the applicable Revenue Acts and regulations. We find no basis for disturbing its findings, and we conclude it correctly applied the law to the facts found. Its decision is affirmed, and the judgment of the Court of Appeals below, reversing it, is reversed".

Under applicable Pennsylvania decisions, the option, since it has a value, is personal property acquired by this petitioner. Under the Pennsylvania rule, it is thus property transmitted at death and subject, as such, to the Pennsylvania Inheritance Tax. *Koch Estate,* 17 Lehigh County Law Journal 281 (Orphans' Court of Lehigh County, decided August 5, 1937); *Bayer v. Walsh,* 166 Pa. 38; *Fleming's Estate* (Fleming's Appeal), 184 Pa. 80; *Dilworth's Estate,* 243 Pa. 475.

In *Koch Estate, supra,* the decedent died testate in Lehigh County, Pennsylvania, on February 10, 1915, leaving surviving him his widow and the children of his deceased brothers and sisters. The assets of the estate consisted in part of the Hotel Allen in Allentown, Pennsylvania, and a store and clothing business known as Koch Bros., located on the hotel premises. Decedent set up a trust fund with income up to $20,000 a year payable to the widow for life. The will contained the following provision in relation to the business:

> "Upon the decease of my wife the persons so accepting and taking over my clothing business or such of them as may at that time stay on and conduct my clothing business shall have the right and privilege of taking the entire store and hotel property as the same may then be at the sum of Two Hundred and Fifty Thousand Dollars; and upon the persons above named accepting the said real estate at the valuation of Two Hundred and Fifty Thousand Dollars and upon paying for the same or securing the same to be paid in a manner satisfactory to my executors, then I order and direct my executors to execute and deliver to them a deed of conveyance in fee simple for said real estate." (Then follows

provision for sale in the event that the property is not accepted as above).

At the time of the widow's death on November 24, 1935, the three men running the business of Koch Bros. were Harry W. Jordan, Samuel Ritter, and John T. Ritter, of whom the latter two were nephews of the decedent and legatees under the will. The three elected to exercise the option and purchased the properties at $250,000.00. But on the death of the life tenant, the widow, the State Inheritance Tax Appraiser appraised the property at $453,250.00. On the audit of the fourth and final account of the surviving executors and trustees, it appeared that they had paid an Inheritance Tax of $22,351.90, on the whole $453,250.00. Two legatees filed an exception to the credit claimed for the $22,351.90 on the ground that the transferees of the store and Hotel Allen should pay an Inheritance Tax on the difference between the appraised value of $453,250.00 and the $250,000.00 price stipulated in the will; that is, $203,250.00.

The Court decided in favor of the exceptants and held that the value of the option was a devise by the testator and that the transaction was not a sale. The Court also held that the transferees were responsible for the payment of the Inheritance Tax on the $203,250.00 option.

The Supreme Court of Pennsylvania has long regarded an option to purchase realty under a will as a devise. *Hanna's Appeal,* 31 Pa. 53; *Bayer v. Walsh,* 166 Pa. 38.

See also: *Fleming's Estate* (Fleming's Appeal), 184 Pa. 80, *supra,* where the option had no value.

On exercise of the option, title to the stock became as absolute in the taxpayer as if there had been a direct bequest in the first instance subject to the payment of a specified sum. *Dilworth's Estate,* 243 Pa. 475.

In *Bayer v. Walsh,* 166 Pa. 38, above, the Court, as part of the reasoning of its decision, held an option to purchase real estate to be property passing by way of devise. In that case, the testator's will provided in part as follows:

> "I give and devise my residence on Brownsville Avenue, valued at $3,000, to my daughter, Alice Walsh, and my sons Edward McMullen and Joseph McMullen to be divided in shares, thus: Alice $1,200, Edward $800 and Joseph $1,000, to hold to themselves and heirs and assigns forever; provided that my daughter, Alice Walsh, may, at her option, within five years of my death, purchase the shares of Edward and Joseph named in this item, price not exceeding the amount bequeathed to each."

Testator died October 19, 1892, and Alice exercised the option on October 31, 1892, purchasing Edward's share at $800.00. On November 1, 1892, execution was issued on a judgment obtained against Edward during his father's lifetime and levy was made on his interest. The Court held that the purchaser at the Sheriff's Sale took no title against Alice. This necessarily means that the option to purchase was a devise under the will.

It is unnecessary to cite further cases from the Pennsylvania Courts, as it is now clear that the option to purchase the stock in the instant case was property passing by bequest, and thus transmitted at death from the testator. The option thus falls squarely within the

purview of Section 113 (a) (5) of the Internal Revenue Code, as amended.

There is nothing in the federal decisions to modify or change this ordinary application of Section 113 (a) (5) that the basis is the value of the option plus the cash paid under it to obtain the stock. In fact they add strength to our proposition as to basis.

In the case of *Harry F. Robertson,* 5 B.T.A. 748, the petitioner's mother-in-law wishing "to do something" for him, deeded him land, which had a stipulated value of $24,000.00, for $16,000.00. He later sold the land for $28,000.00. It was held that his basis was $24,000.00 instead of only $16,000.00, the amount of cash he paid for the land. The balance of the $24,000, namely, $8,000.00, was a gift. The gift was in 1920, when its basis was fair market value at the date of the gift (prior to December 31, 1920). Necessarily, the Board thus ascribed to basis the $8,000.00 value of the gift. Just so, the value of the bequest should be included in the basis. To the same effect is *G. Wildy Gibbs,* 28 B. T. A. 18, See further: *Hawke v. Com.,* 190 F. (2d) 946, 24 A.F.T.R. 438, and similar cases involving sales to employees of the employer's capital stock at less than fair market value.

In commenting on the Commissioner's contention that "cost" is equivalent to "cash paid", in the *Hawke* case, Judge Haney (dissenting on other grounds) said in part:

> "The 'cost' respondent argues, is the amount paid. The word 'cost' is defined as follows: 'The amount or equivalent paid, or given, or charged, or engaged to be paid or given for anything bought or

taken in barter or for services rendered * * *' Merriam's Webster's Dict. (2nd Ed.). Under this definition, the 'cost' to petitioner was the amount of cash be paid and the value of the services rendered. Nothing in the act or the regulations promulgated thereunder indicate that the word 'cost' was used in a restricted sense."

The pertinent portions of Section 113 (a) (5) of the Internal Revenue Code, as amended, are set out above. It will be noted that the section provides in part that if property is acquired by bequest, the basis shall be the fair market value of such property at the time of such acquisition. It will be agreed that the time of acquisition of the option was the date of the death of the decedent, John S. Mack, namely, September 27, 1940. If the option was property, then, where a taxpayer uses this property right plus cash to acquire shares of stock, the basis of the shares of stock should obviously be the sum of the property value of the option plus the cash thus expended.

The conclusion that the option is property of a valuable kind is realistic, factual, and ordinary common sense.

Once having established the fact that the option was valuable property, its inclusion in petitioner's basis on sale of the shares follows from the provisions of Section 111, Section 112 (a) and Section 113 (a) (5) of the Internal Revenue Code as amended. These sections are set out in the Appendix.

Insofar as pertinent to this case, the sections provide as follows: Section 111, that the gain on the sale is the difference between the amount realized and the

adjusted basis of the shares; Section 112 (a), that the entire amount of the gain on the sale is recognized; Section 113 (a) that the basis of property is its cost, with exceptions named in Section 113, the fifth of which, in 113 (a) (5), is that property acquired by bequest from a decedent takes a basis of its fair market value at the date of the decedent's death.

Thus, since the option was property (see Pennsylvania cases above quoted); and since it had a value; the basis is not only the cash paid by the petitioner, but in addition the fair market value of the option at the date of the decedent's death.

If it be contended that the real gain to petitioner arose on his exercise of the option given to him in his father's will, the result here is the same. For the option to acquire at lower than market obviously had a value and was property. Property transmitted as a bequest does not constitute taxable income to the beneficiary. But the latter (the petitioner) then has a share of stock having a market value. And that market value would be subtracted from the net sale price (amount realized) on petitioner's subsequent sale of the stock. The value of the option is automatically included in the market value.

In *Mehrengood Corporation (Del.) v. Helvering,* 89 F. (2d) 972, (C. A. of D. of D.), cert. den. 302 U. S. 714, the taxpayer acquired stock of Blair & Co., Inc., a banking house, from one Henry Lockhart, Jr., who had an executive position with the banking house. The acquisition was of such a character that the basis of Lockhart carried through to the stock in the hands of the taxpayer corporation. In 1924, Blair & Co. offered

Lockhart a position in its organization and as an inducement to the employment, gave him an option to acquire 5,000 shares of its common capital stock at book value on December 31, 1924. The stock was "not actively traded in, but it was customarily traded in at its book value". The Mehrengood Corporation exercised the option "in connection with further options not important here" on December 31, 1925, at a cost to it of $96.48, per share. At that time the market value was $227.00 per share. Subsequently, in 1927, Mehrengood Corporation sold the stock at a price below the said value of $227.00, but higher than the value of $96.48. The taxpayer claimed that its basis for determining gain or loss on the 1927 sale was $227.00 a share, which was the fair market value on the date of its acquisition. The Commissioner maintained that the basis was $96.48, which was the amount paid by the taxpayer for the stock. Mehrengood argued that the option was given to Lockhart in part compensation for services; that it was renewed from time to time until, on its exercise on December 31, 1925, the stock had greatly increased in value; and that there should be added to basis the value of the option calculated on the difference between the option price and the fair market value of the stock on the date of the exercise of the option.

The Commissioner argued, however, that the option had no value at the time it was acquired by Lockhart, namely, twelve months previous to its exercise and that it could not be given value as compensation for services rendered. The Court, after holding that the option was not given as compensation for services, also found that *inasmuch as the option merely permitted Lockhart to buy at what was fair market value it, therefore, had no value sufficient to justify its addition to his cost basis.*

It is to be noted that the court used as a criterion, the value of the option at the time it was acquired and not at the time it was exercised. Similarly, the taxpayer had used the value of his option at the date of the death of the decedent and not at the date of its exercise. In the *Mehrengood* case, the option had no value at the date of its acquisition, because it was to acquire at market. In our case, the option has a value because it is to acquire at much less than market.

See also: *Gordon M. Evans,* 38 B. T. A. 1406 (option to acquire at fair market value); and *Hawke v. Commissioner,* (C.C.A. 9), 109 F (2d) 946; *Commissioner v. Matheson,* (C.C.A. 5) 82 F (2d) 380, where the transaction was held to be an outright sale and basis on later disposition of the stock bought was the agreed selling price.

In *Joseph W. Robinson v. Commissioner,* (C.C.A. 6) 59 F (2d) 1008, a taxpayer acquired shares of his employer corporation's capital stock, through a contract with the corporation, for much less than its market value at acquisition. The Sixth Circuit reversed the Board, and held that the basis on future sale was the *cash paid plus the difference between such cash and fair market value at* acquisition. Judge Hickenlooper, speaking for a unanimous court, said in part:

> "* * * Whether regarded as a gift or as compensation, it is evident that the surplus value, over and above the actual price paid for the shares, must be taken into consideration in determining the capital base, and that such base is to be fixed at the true or market value at the time the stock was acquired."

In the instant case, too, the "surplus value" of the option "over and above the actual price paid for the shares" must be considered "in determining the capital base" of the five shares thus acquired.

In the case of *Realty Sales Co.,* 10 B.T.A. 217, (Acq.), the petitioner issued $25,000 worth of its capital stock for an option to purchase certain real estate in Fulton County, Georgia, for $69,037.50. Later the real estate was sold by the corporation at a gain. As stated by Member Morris:

> "The question raised is whether, in determining the gain on the sale of the property therein, the cost of the option should be included as a part of the property to the petitioner. * * * Finding as we do that the option had a value of $25,000, the issuance by the corporation of its capital stock in that amount represents additional cost to it of all the property subsequently purchased upon the exercise of the option, which additional cost should be taken into consideration in determining the gain derived from the sale of the property."

See also: *Isabel Anderson,* 5 B.T.A. 27, holding that value of option to purchase stock enters into the computation of the cost of the stock purchase in determining amount of gain or loss on the sale thereof; *Safe Deposit & Trust Co. v. Miles,* 273 Fed. 822, affirmed, *sub nomine Miles v. Safe Deposit & Trust Co.,* 259 U. S. 247.

In its majority opinion, The Tax Court adverts to the fact that the option was personal to the petitioner and that what he sold was the stock and not the option. That court failed to understand the *rule laid down in*

the statute, that the basis of property is not only the money paid for it but also any property paid for it or statutory substitutes for such payment. Examples are easy to find. For instance, a horse acquired in exchange for ten dollars and a forty-dollar mule has a basis of fifty dollars for subsequent calculation of gain or loss on a sale of the horse. Stock acquired in exchange for a twenty dollar privilege plus fifteen dollars has a thirty-five dollar basis. The stock here was acquired through the exercise of a right which had a property value. The exercise of the right is its exchange. The stock resultantly acquired thus has a basis of the value of the right plus the cash paid in addition.

We do not read *Merrell v. Evans,* (D. C. Idaho), 8 F. (2d) 431, as does Judge Smith in speaking for the Tax Court. (R. 34 A). The case involved an alleged overpayment of income taxes. The question for decision was the proper basis to be used by the plaintiff on the sale of securities obtained by him from a testamentary trust of which he was a beneficiary. The trust provided, *inter alia,* that any "beneficiary" *desiring to sell stock of this kind must first offer* it to the other beneficiaries at par. On the date of the purchase by the plaintiff, Merrell, the stock was of a higher market value than par. Consequently, plaintiff claimed that his basis should be higher than the actual cash consideration paid. It was suggested that the privilege of purchasing at par was of value and such value was to be added to basis. In answer to this contention, Judge Dietrich stated that he was "unable to see the materiality of the privilege which plaintiff had under the will of purchasing at par in case another beneficiary chose to sell". It was held that the basis was the amount paid. In our

case, no choice is to be exercised by the "seller", namely, the trustees. They are required to "sell" upon request by either of the two named beneficiaries. The distinction lies in the absolute character of the requirement in the instant will.

In *Commissioner v. Merrell,* 93 F. (2d) 466 (C.C.A. 2), the Court may have been considering a case arising under the same will as that considered in *Merrell v. Evans, supra,* although the latter arose in Idaho and the former went to the Board of Tax Appeals and subsequently to the Second Circuit, apparently on a return filed in New York. The taxpayer and his two brothers were executors, testamentary trustees, and also beneficiaries of the will of their father who died in 1909. In 1919, they, as trustees, sold to themselves as individuals, corporation stock comprising the corpus of the trust at $100.00 a share, giving their promissory notes for the purchase. The notes were returned to them on final distribution of the estate. The stock thus acquired by the individuals, including taxpayer, was exchanged in 1928, pursuant to a plan of reorganization. The taxpayer sold his new stock acquired in the reorganization in 1930. It was held that the basis of the latter was the price paid for it, namely, $100.00 a share, which was the price agreed upon by the trustees and beneficiaries, although, at the time of the sale, the market value of the stock was $800.00.

The Court held that the sale in 1919 was an arm's length transaction.

The taxpayer contended that he was entitled to use as a basis for his stock, $800.00 a share, which was its

value at the date of the 1919 sale, although, under his option, he acquired it at $100.00 a share. The Commissioner contended that the proper basis was par value, namely, $100.00 a share, which was the agreed selling price. The difference between this case and our own is that the Merrell trustees did not have to sell, but were merely required, if they did decide to sell, to first offer to the taxpayer and his brothers at par. Such Agreement was the occasion for the acquisition, so that nothing was acquired by death. In our case, the trustees are compelled, on request, to transfer whether at the moment they desire to do so or not. This right was acquired by death and not by subsequent agreement. Hence, while the Court stated that there was no value to the option in the *Merrell* case, nevertheless, in our case, the option has a value on account of such absolute requirement. Indeed, in the *Merrell* case, *the Court went on to state that if the "taxpayer" had had the right to acquire at less than real value, the reasoning of the taxpayer "might apply".* But the Court found against the taxpayer on the facts.

The respondent has contended that because the petitioner had to exercise his rights under his father's will himself, and could not sell this right, the petitioner's bequest had no value. If you had the right to buy a block of stock listed on the stock exchange for one-half the market price, you would be foolish not to exercise the right and then of course you could sell the stock the same day, if you chose. We, therefore believe that any argument based on such a proposition that petitioner's bequest is non-assignable is impractical to the point of being absurd.

Conclusion.

The decision of the Circuit Court of Appeals is erroneous and should be reversed.

Respectfully submitted,

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